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No. 85-1385

In the Supreme Court of the United States

OCTOBER TERM, 1986

UNITED STATES OF AMERICA, PETITIONER

v.

GENERAL DYNAMICS CORPORATION, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether a taxpayer using the accrual method of tax accounting is entitled to deduct, as a fixed liability at the close of its taxable year, an addition to a reserve for future expenses expected to be paid under an employee medical reimbursement plan, where the addition is based on the taxpayer's estimate of its liability to employees who were assumed to have received medical care during the year, but who had not submitted claims for payment, or whose claims for payment had been submitted but not approved, before the close of the taxable year.

PARTIES TO THE PROCEEDING

In addition to the parties named in the caption, Datagraphix, Inc., Material Service Corporation, Marblehead Lime Corporation, and General Dynamics Land Systems, Inc. (formerly Stromberg-Carlson Corporation), are respondents. Each is a wholly-owned subsidiary of General Dynamics Corporation.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-5a) is reported at 773 F.2d 1224. The opinion of the Claims Court (Pet. App. 6a-18a) is reported at 6 Cl. Ct. 250.

JURISDICTION

The judgment of the court of appeals (Pet. App. 20a) was entered on September 19, 1985. On December 9, 1985, the Chief Justice extended the time within which to petition for a writ of certiorari to and including February 16, 1986 (a Sunday preceding a

federal legal holiday). The petition was filed on February 18, 1986, and was granted on June 16, 1986 (J.A. 179). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

The relevant portions of Sections 162, 446, and 461 of the Internal Revenue Code of 1954 (26 U.S.C. (& Supp. II)), and of Sections 1.446-1 and 1.461-1 of the Treasury Regulations on Income Tax (26 C.F.R.), are set forth at Pet. App. 21a-26a.

STATEMENT

1. For many years respondent General Dynamics Corporation and its subsidiaries have been required by collective bargaining contracts to maintain medical benefit plans for their employees.[1] Under these benefit plans, employees pay the first $100 of covered charges (generally called "the deductible") before becoming eligible for benefits. After that, employees generally are entitled to reimbursement for 80% of the covered medical costs that they or their dependents incur (J.A. 64). Certain items—such as expenses related to pregnancy and childbirth, the costs of footcare and eyeglasses, the costs of "checkup examina-

[1] The tax controversy at issue arises out of a single consolidated income tax return filed by General Dynamics Corporation on behalf of itself and its respondent subsidiaries. See Pet. App. 10a; Sections 1501-1505 of the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.). For convenience, we will use the term "respondent" to refer to the respondent corporations collectively. Although each corporation maintains its own medical benefits plan, there is no significant difference between the plans' respective modes of operation.

tions and tests not reasonably necessary to medical treatment"—are not covered by the plans (J.A. 54-56). In the case of otherwise-covered items, employees are not entitled to reimbursement if the treatment is for work-related injuries, if the treatment is furnished by an unapproved practitioner, if the expenses are incurred within 30 days of an employee's entry into the plan, or if the expenses are attributable to certain pre-existing conditions (J.A. 55, 56-57, 61, 162-164). The plans specify a maximum amount allowable per illness, a maximum amount allowable for each particular treatment or procedure, and a daily limit on hospital charges (J.A. 48-53, 63-77). The plans also specify that reimbursement will not be made for expenses in excess of the provider's usual charge for a particular treatment or procedure, or in excess of the customary charge prevailing in the neighborhood (J.A. 58, 160-161).

In order to obtain reimbursement under respondent's health plans, a covered employee must submit a claim for benefits on a standard form (Pet. App. 7a; J.A. 23). The claim must be accompanied by itemized bills evidencing the amount paid and specifying the diagnosis and treatment given (Pet. App. 7a-8a; J.A. 23). Respondent has no obligation to make any payment unless and until an employee has submitted a properly-documented claim for benefits and the claim has been determined to qualify for payment by respondent's claims examiner. See Pet. App. 7a-8a.

2. Prior to October 1, 1972, respondent supplied the health benefits outlined above by purchasing group medical insurance from two outside carriers, Aetna Life Insurance Company and Prudential Insurance Company. Insurance companies are generally required by state law to maintain certain "reserves"

with respect to the insurance coverage that they provide. In the case of the medical insurance coverage that Aetna and Prudential provided to respondent's employees, both companies prior to October 1, 1972, maintained reserves for health claims that they estimated (1) had arisen, but had not yet been reported to them, or (2) had been reported to them, but had not been processed or approved for payment (Pet. App. 8a). These reserves represented a statistical estimate, based on each carrier's past experience, of the amount that it would ultimately have to pay with respect to such actual or potential claims. Reserves of this sort are usually called "incurred but not reported," or "IBNR," reserves (*ibid.*). Under the special tax provisions applicable to insurance companies, an insurance company, unlike other taxpayers, is generally permitted to deduct additions to reserves (including IBNR reserves) that are required by state law. See I.R.C. § 807 (life insurance companies), § 832(b)(5) (casualty insurance companies).

On October 1, 1972, respondent became "a self-insurer of its medical care plan" (Pet. App. 2a, 7a). In other words, rather than purchasing insurance by the payment of premiums to outside carriers, respondent accepted the responsibility to pay employee medical claims out of its own funds. Although respondent thus ceased paying insurance premiums to Aetna and Prudential, those companies continued to administer the plans for a fee under service agreements (Pet. App. 7a). This shift to self-insurance entailed no change in the medical benefits provided to respondent's employees. From their perspective, the only difference was that their health-benefits checks thenceforth were drawn on a different bank and by a different payor. Respondent's shift to self-insurance likewise entailed no change in the claims-processing

procedure or in the personnel responsible for implementing it. Employees' claims continued to be screened in the first instance by the claims department at respondent's plants and then to be forwarded to the insurance company for evaluation and approval (*ibid.*).

In conjunction with its becoming a self-insurer, respondent agreed to accept responsibility for all as-yet-unfiled or unpaid claims arising out of medical services rendered before October 1, 1972. On that date, respondent took an amount equal to the aggregate IBNR reserves that Aetna and Prudential had previously maintained for those claims and set that amount up as a liability on its own books. On December 31, 1972, using statistics supplied by those companies, respondent calculated an estimate of its liability to employees who were assumed to have received medical care during the last three months of 1972, but who had not submitted claims, or whose claims had been submitted but not yet processed. The amount thus calculated was added to the beginning IBNR reserve balance that respondent had inherited from the insurance companies. Respondent then calculated the amount that it had actually paid out on approved claims during the final quarter of 1972. That amount was subtracted from the reserve balance. See Pet. App. 8a-9a; J.A. 27-33. These calculations (together with other minor adjustments) produced a year-end IBNR reserve balance in the amount of $5,575,289, representing respondent's estimate of its anticipated liability to pay benefits on claims arising from pre-1973 medical treatment (Pet. App. 10a; J.A. 33-34).

During 1973 and 1974, respondent actually paid out $4,583,893 in benefits on claims arising from pre-

1973 medical treatment (Pet. App. 16a). This sum was approximately $1 million (or 17.8%) less than the amount that respondent had reserved to pay such claims (*ibid.*). In the courts below, respondent presented no evidence that would indicate what portion either of its $5.5 million IBNR balance or of the $4.5 million actually paid represented medical treatment for which claims had not been filed as of December 31, 1972, as opposed to treatment for which claims had been filed but not yet processed.

It has been the experience of Aetna and Prudential that about 90% of the amounts for which respondent's employees claim reimbursement are actually approved for payment (Pet. App. 12a). As to the balance, the claims are rejected in whole or in part because they fail to qualify for reimbursement under the terms of the plans for one or more reasons. An expense would fail to qualify, for example, if the medical treatment were not a "covered service," if the employee's "deductible" had not been satisfied, if a specified maximum charge had been exceeded, or if the treatment were not deemed "medically necessary." See J.A. 48-57.

3. Respondent uses the accrual method of accounting for federal tax purposes. On its consolidated federal income tax return for calendar year 1972, respondent originally did not deduct any portion of its IBNR reserve in computing its tax. In 1977, however, after the IRS had commenced an audit of that return, respondent filed an amended return for 1972, claiming that it was entitled to deduct the 1972 year-end balance of its IBNR reserve ($5,575,289) as an ordinary and necessary business expense incurred during that taxable year. See I.R.C. § 162; J.A. 36.

The Commissioner denied respondent's claim for refund because the deduction sought for the IBNR reserve failed to satisfy the so-called "all events" test of tax accounting. That test provides that, under the accrual method of accounting, an expense may not be deducted until "all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy" (Treas. Reg. § 1.461-1(a)(2)). The Commissioner determined that the events that would fix respondent's liability to pay for a particular employee's medical treatment would be that employee's submission of a properly-documented claim for reimbursement, and respondent's determination that the claim qualified for payment, in some post-1972 tax year. Until those events occurred, the Commissioner concluded, respondent's obligation to pay was contingent and hence did not give rise to a deductible expense during the 1972 taxable year.

4. Following the denial of its administrative claim for refund, respondent filed this refund suit in the Claims Court, which ruled in its favor (Pet. App. 6a-18a). The court held that the last event necessary to fix respondent's liability to reimburse its employees occurs "when a qualified employee or dependent receives covered medical services" (*id.* at 11a, 13a). In the court's view, an employee's submission of a claim for benefits and respondent's evaluation of it with a view to determining whether or not it qualifies for payment constitute mere "clerical," "administrative," or "ministerial" steps that are not "condition[s] precedent to establishing the fact of liability" (*ibid.*). The court held, moreover, that respondent, in order to establish the fact of its liability, need not demonstrate "any specific liability to particular em-

ployees who received treatment" (*id.* at 9a). Rather, it was sufficient for respondent to "estimate [its] aggregate liability" to its employees as a group, basing its estimate on a statistical probability that a certain quantum of covered medical services had been rendered to covered recipients (*ibid.*). The court noted that respondent's method of computing its IBNR reserve "reflected accepted insurance company practice" and that "insurance companies can and do deduct such reserves" (*ibid.*). The court also ruled that, because respondent ultimately paid out 82.2% of the amount reserved, its estimate satisfied the "reasonable accuracy" prong of the "all events" test (*ibid.*). The court accordingly held that respondent was entitled to deduct the entire 1972 year-end balance of its IBNR reserve as a business expense "incurred during the taxable year" (I.R.C. § 162(a)).

The Federal Circuit affirmed (Pet. App. 1a-5a). The court stated that the issues had been "thoroughly treated in the trial court's opinion" and that the only question that it "need[ed] to address on appeal" was whether the decision below was contrary to Court of Claims precedent (*id.* at 1a-2a). The Federal Circuit answered that question in the negative and proceeded to "affirm * * * on the basis of the Claims Court opinion" (*id.* at 5a).

SUMMARY OF ARGUMENT

A. Taxpayers using the accrual method of accounting may not deduct business expenses until the year in which the obligation to pay has become "fixed and certain." See, *e.g.*, *United States* v. *Hughes Properties, Inc.*, No. 85-554 (June 3, 1986), slip op. 7. One of the major consequences of this tax accounting system is that, in the absence of special authoriza-

tion by Congress, a taxpayer is not entitled to take a current deduction for amounts set aside as reserves to cover anticipated future expenses, even though the use of such reserves is an accepted financial accounting practice. Reserve accounting, including the IBNR reserve that respondent seeks to deduct here, is useful in giving a picture of a corporation's financial condition, and it advances the principle of accounting conservatism by accruing liabilities as soon as they can be estimated, thereby erring on the side of understatement of income. Because this principle is in considerable tension with the goal of the tax system to protect the public fisc, and because the tax system demands certainty, not estimation, it has long been recognized that reserve accounting is generally unacceptable as a method of accounting for tax purposes. See generally *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 541-543 (1979).

Congress has, on occasion, given specific attention to whether the general rule against the use of reserve accounting should be modified. In the interest of establishing greater conformity between tax and financial accounting, the Internal Revenue Code of 1954 originally contained a provision allowing a deduction for additions to reserves for estimated expenses, a provision that would have permitted the deduction sought by respondent here. Indeed, the legislative history of that provision explicitly listed estimates of "certain liabilities for self-insured injury and damage claims" as among the expenses that could be deducted under it. See H.R. Rep. 1337, 83d Cong., 2d Sess. A163 (1954). However, Congress soon recognized that this acceptance of reserve accounting would have a disastrous impact on the government's revenue, and it repealed this provision

retroactively less than a year later, thereby restoring the status quo ante under which the deduction of reserves is not permitted. See generally *American Automobile Ass'n* v. *United States*, 367 U.S. 687, 694-697 (1961).

Since 1921, the Code has contained special provisions relating to the taxation of insurance companies, and these provisions permit life and casualty insurance companies to deduct IBNR reserves. Respondent is not an insurance company, however, and it is not entitled to the same special treatment simply because it mimicked insurance company practice in setting up its own IBNR reserve. This is so both because the terms of the Code limit the availability of this deduction to insurance companies and because the tax policies that underlie this exception have no application to companies like respondent that are not in the insurance business. See generally *Brown* v. *Helvering*, 291 U.S. 193, 201 (1934). On the contrary, the fact that Congress took special action to make these reserves deductible for insurance companies, coupled with the fact that Congress repealed a provision that would have made them deductible for all taxpayers, strongly suggests that respondent may not take a current deduction for its additions to its IBNR reserve in the absence of specific authorization by Congress. This reserve is little different from any other reserve established by a taxpayer in anticipation of probable future expenses, and it is clear under the Code that such reserves are not deductible because they do not represent a "fixed and certain" obligation to pay.

B. Respondent's attempt to deduct additions to its IBNR reserve clearly fails the "all events" test, which has been the standard for almost 60 years for

determining when an item of expense is to be regarded as "incurred" for federal tax purposes. The first part of the test provides that an expense may not be deducted until "all the events have occurred which determine the fact of the liability" (Treas. Reg. § 1.446-1(a)(2)). That standard is not satisfied here. Respondent's IBNR reserve is designed to estimate future liability for medical services obtained during the taxable year, but for which a claim either has not been filed, or has been filed but not yet processed or approved. Under the terms of its health plans, however, respondent is not required to make any reimbursement for medical services until both of these events occur—the filing of a claim and its approval for payment. Accordingly, the $5,575,289 estimate of future liability contained in respondent's reserve did not represent a "fixed and certain" obligation to make a payment.

An employee's receipt of medical services by itself creates no obligation on the part of respondent to pay reimbursement. It is true that respondent at that point reasonably can anticipate that it will have a future obligation to reimburse the employee if he files a claim and his claim is approved. But this anticipated obligation is no more certain than the future liability that respondent could have anticipated at the time it originally entered into the collective bargaining contracts under which the health plans were created. It was entirely possible that some of the employees who received medical services in 1972 would never file a claim—because of inadvertence, a desire to keep their employer from learning of certain medical conditions, or other reasons—and hence respondent would never be obligated to pay reimbursement for those expenses. Even as to

employees who had filed claims in 1972, moreover, it was by no means certain that the claims would be approved for payment. They could be denied in whole or in part if respondent determined that the charges were not reasonable or customary, that the services were not medically necessary, or that the treatment was for a preexisting condition. In short, until a claim for medical services is filed and is approved for payment by respondent, any reimbursement liability under the plans is contingent, not fixed and certain.

Moreover, the amount of respondent's IBNR reserve does not reflect any *actual* obligations, fixed or otherwise. Respondent's $5.5 million figure was not based on knowledge of even a single individual receipt of medical services; it was nothing more than an educated guess as to aggregate liability based on past experience. This sort of aggregate estimate is incompetent as a matter of law to "establish the fact of the liability" (Treas. Reg. § 1.446-1(c)(1)(ii)). A liability can become "fixed" and satisfy the "all events" test only when it is based on known facts respecting individual claimants. See *American Automobile Ass'n* v. *United States*, 367 U.S. at 692.

ARGUMENT

A RESERVE ESTABLISHED TO COVER THE ESTIMATED COST OF REIMBURSING EMPLOYEES FOR MEDICAL SERVICES ASSUMED TO HAVE BEEN RENDERED DURING THE TAXABLE YEAR, WHERE PAYMENT IS CONTINGENT UPON THE FILING AND PROCESSING OF QUALIFIED CLAIMS IN FUTURE YEARS, IS NOT AN EXPENSE "INCURRED DURING THE TAXABLE YEAR" AND HENCE CANNOT GIVE RISE TO A CURRENT BUSINESS-EXPENSE DEDUCTION FOR AN ACCRUAL-BASIS TAXPAYER

Respondent in this case seeks to take a current tax deduction for amounts set up as a reserve to cover estimated payments expected to be made to its employees in future years. In constructing this "IBNR reserve," respondent made no attempt to ascertain whether any employee had in fact received medical services before the close of its tax year. Nor did respondent endeavor to ascertain whether employees who had received medical services would seek or were seeking reimbursement for them. Rather, respondent's IBNR reserve represented a mere projection of its estimated liability, based on statistics concerning claims paid in past years and on the previous "lag time" between its employees' receipt of services and its insurers' tender of payment. See Pet. App. 9a & n.1. Respondent contends that the amount of this IBNR reserve—a reserve computed in precisely the same manner that life and health insurance companies compute their reserves—is an expense "incurred during the taxable year" (I.R.C. § 162(a)) that can be deducted currently by an accrual-basis taxpayer.

This contention flies in the face of long-recognized tax accounting principles. First and foremost, it erases the basic distinction between reserves set up

for financial accounting purposes to reflect anticipated future expenses and specific, identifiable obligations that are genuinely "fixed" within the meaning of the tax law. Second, it allows the current deduction of a particular type of reserve that Congress and the courts have indicated quite clearly is not available to ordinary accrual-basis taxpayers but rather is available only to insurance companies. Finally, respondent's contention rests on a serious misinterpretation of the "all events" test, which establishes two prerequisites to the accrual of an expense —"all the events [must] have occurred which determine the fact of the liability and the amount thereof [must] be determin[able] with reasonable accuracy" (Treas. Reg. § 1.461-1(a)(2)). The court of appeals' acceptance of respondent's contention marks a sharp departure from well-established rules of tax accounting—one that threatens a serious erosion of the fundamental principle that a taxpayer may not deduct, absent specific congressional authorization, reserves set up to cover contingent future expenses.

A. The Amount Of Respondent's Estimated Future Medical Reimbursements Is Not An Expense Incurred During The Taxable Year, But Rather Is A Reserve For Future Expenses That Cannot Be Currently Deducted Because Its Use For That Purpose Has Not Been Specifically Authorized By Congress

1. a. Section 162 of the Code allows a deduction for business expenses "paid" or "incurred" during the taxable year. A taxpayer who uses the "cash receipts and disbursements method" of accounting (I.R.C. § 446(c)(1)) is entitled to deduct business expenses only in the year in which they are paid. Treas. Reg. §§ 1.446-1(c)(1)(i), 1.461-1(a)(1). A taxpayer who uses the "accrual method" of accounting (I.R.C. § 446(c)(2)), as respondent does, is en-

titled to deduct expenses in the year they are "incurred" regardless of when the expenses are actually paid. Treas. Reg. § 1.461-1(a)(2); see *United States* v. *Anderson*, 269 U.S. 422, 424 (1926). It is well settled that " 'to incur' means to become liable or subject to." *Ox Fibre Brush Co.* v. *Blair*, 32 F.2d 42, 47 (4th Cir. 1929), aff'd *sub nom. Lucas* v. *Ox Fibre Brush Co.*, 281 U.S. 115 (1930). "[A] liability does not accrue as long as it remains contingent," even if it is quite probable that an obligation to pay the liability will become fixed in the near future. *Brown* v. *Helvering*, 291 U.S. 193, 200 (1934). See, *e.g.*, *United States* v. *Hughes Properties, Inc.*, No. 85-554 (June 3, 1986), slip op. 6-7; *Dixie Pine Co.* v. *Commissioner*, 320 U.S. 516, 519 (1944). " 'The tax law requires that a deduction be deferred until "all the events" have occurred that will make it fixed and certain.' " *United States* v. *Hughes Properties, Inc.*, slip op. 7 (quoting *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 543 (1979)).

One of the major consequences of this tax accounting system is that taxpayers ordinarily are not entitled to take current deductions for amounts set aside as reserves to cover anticipated future expenses. Such reserves are of course a common and entirely appropriate feature of commercial or financial accounting. Reserve accounting attempts to paint an accurate picture of a company's financial condition by reporting the anticipated results of transactions at the end of a given year, even though the transactions may not be complete and even though those results must be estimated. This is done through the use of an ongoing reserve account to accumulate estimates of aggregate expenses expected to be paid in the future, correcting in subsequent years the errors

inherent in predicting future events.[2] Accepted financial accounting principles encourage the practice of using reserves to cover estimates of future expenses that probably will be incurred. See generally H. Finney & H. Miller, *Principles of Accounting, Interme-*

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[2] Mechanically, a reserve is nothing more than an entry in an accounting record. *Geyer, Cornell & Newell, Inc.* v. *Commissioner*, 6 T.C. 96, 100 (1946). In the first year a reserve is used, the estimated expense is deducted from revenues and is added to the reserve account, which is carried as a liability on the company's balance sheet. The effect of this is to reduce the company's reported income for year one. In a subsequent year, when the previously estimated expense is finally paid, the actual cost incurred is charged to (removed from) the reserve instead of being charged as an expense against that year's income. Any differences between the actual amount paid and the estimated amount is accounted for at the end of the later year. See, *e.g.*, *Levelland Savings & Loan Ass'n* v. *United States*, 421 F.2d 243, 247 (5th Cir. 1970); *Hawes Corp.* v. *Commissioner*, 44 T.C. 705, 707-709 (1965). At the end of each succeeding year, the total amount of estimated liability is compared to the reserve balance. If the former exceeds the latter, an addition is made to the reserve, and is treated as an expense in that year, in the amount necessary to bring the reserve balance up to the total amount of estimated liability. Conversely, if the reserve balance exceeds the total amount of estimated liability, the reserve is reduced accordingly, and the amount of the reduction is taken into income. Because additions to and reductions of the reserve represent the difference between the amount of estimated liability and the reserve balance, the reserve is self-correcting over time; excessive estimates in a prior year are corrected by recording a smaller expense for additions to the reserve in subsequent years. See, *e.g.*, *Bird Management, Inc.* v. *Commissioner*, 48 T.C. 586, 595-597 (1967); *Calavo, Inc.* v. *Commissioner*, 304 F.2d 650, 654 (9th Cir. 1962). A reserve thus does not operate to increase the amount of an expense but rather to accelerate the time at which the expense is offset against income. See *Knight-Ridder Newspapers* v. *United States*, 743 F.2d 781, 799 (11th Cir. 1984).

diate 381-390 (7th ed. 1979). Indeed, in order to advance "the principle of conservatism," financial accounting rules "typically require that a liability be accrued [by establishing it on the books as a reserve] as soon as it can reasonably be estimated." *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. at 541, 542. See, *e.g.*, *Commissioner* v. *Hansen*, 360 U.S. 446, 448 (1959) (reserve to cover contingent liability in event of nonperformance of guarantee); *Brown* v. *Helvering*, 291 U.S. at 196-197 (reserve to cover expected liability in likely event of insurance policy cancellations); *Lucas* v. *American Code Co.*, 280 U.S. 445, 447 (1930) (reserve to cover contingent liability on contested lawsuit). The effect of reserve accounting is thus to accelerate expenses into the *earliest* year in which it is possible to make a reasonable prediction that those expenses will occur, with a corresponding reduction in income as reported for financial accounting purposes for the year in question.

Although reserve accounting is indisputably a legitimate and useful method of financial accounting,[8] it is as a rule inconsistent both with the overall objective and with the practical operation of the accrual method of accounting used for tax purposes. Under the tax accrual method, the goal is to assign to each taxable year the individual items of income and deductions that the taxpayer has become entitled to receive or has become obligated to pay. That accrual method does not allow reporting of any par-

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[8] This Court has referred to the use of a reserve as a "method of accounting." *Nash* v. *United States*, 398 U.S. 1, 2 (1970); *Brown* v. *Helvering*, 291 U.S. at 197. See also *Knight-Ridder Newspapers* v. *United States*, 743 F.2d at 797-800; H.R. Rep. 1337, 83d Cong., 2d Sess. 48-49 (1954); S. Rep. 1622, 83d Cong., 2d Sess. 300 (1954).

ticular item until the right to receive it or the obligation to pay it has become fixed and certain. It is this certainty that makes the accrual method acceptable for tax accounting. By the same token, the uncertainty of reserve accounting, which relies on the aggregation of estimates of future expenses and the correction in subsequent years of the errors inherent in making such predictions, renders that method unacceptable for tax purposes.

It is well settled that reasonable financial accounting methods are often impermissible under the tax law. To say that a taxpayer's accounting practice " 'is in accord with generally accepted commercial accounting principles,' " this Court has observed, "is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury." *American Automobile Ass'n* v. *United States*, 367 U.S. 687, 693 (1961) (footnote omitted). In particular, this Court has long recognized that reserve accounting is generally unacceptable in computing taxable income. In the words of Justice Brandeis, speaking for the Court: "The prudent business man often sets up reserves to cover contingent liabilities. But they are not allowable as deductions." *Lucas* v. *American Code Co.*, 280 U.S. at 452 (footnote omitted).

The Court recently reconfirmed and elaborated upon this proposition, emphasizing "the vastly different objectives that financial and tax accounting have." *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. at 542. "The primary goal of financial accounting is to provide useful information to management, shareholders, [and] creditors" and thereby "to protect these parties from being misled" (*ibid.*). Moreover, "financial accounting has as its foundation the principle of conservatism, with its corollary that 'pos-

sible errors in measurement [should] be in the direction of understatement rather than overstatement of net income'" (*ibid.*, quoting AICPA Accounting Principles Board, *Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises* ¶ 171 (1970)). Therefore, "accounting principles typically require that a liability be accrued as soon as it can reasonably be estimated" (439 U.S. at 543 (footnote omitted)). By contrast, "[t]he primary goal of the income tax system * * * is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc" (*id.* at 542). These missions, the Court explained, are incompatible with financial accounting techniques, such as reserves, that are skewed toward understatement of income. The Court accordingly concluded that, "[g]iven this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable" (*id.* at 542-543 (footnote omitted)). Of particular relevance to the instant case, the Court noted that "divergence between tax and financial accounting is especially common when a taxpayer seeks a current deduction for estimated future expenses or losses" (*id.* at 541) —the precise situation involved here.

b. This Court's frequent pronouncements about the differences between tax and financial accounting, particularly concerning the use of reserves, have long sounded a doleful chord in taxpayers' ears, and 32 years ago, they briefly won relief from Congress. As this Court pointed out in *American Automobile Ass'n, supra*, Congress in 1954 temporarily adopted provisions that would have permitted deferral of income (Section 452 of the Code) as well as the deduction of anticipated expenses (Section 462 of the Code) by

the use of the reserve method of accounting employed by respondent here. See 367 U.S. at 694-697. Section 462 authorized a deduction by accrual-basis taxpayers of "a reasonable addition to [a] reserve for estimated expenses," with "estimated expenses" being defined to include deductions "attributable to the income of the taxable year or prior taxable years." Internal Revenue Code of 1954, ch. 736, § 462(a) and (d)(1)(B), 68A Stat. 158-159. See *id.* § 452(a), 68A Stat. 152 (companion provision permitting deferral of prepaid income). Section 462 was designed to bring "[t]ax accounting * * * more nearly in line with accepted business accounting * * * by allowing reserves to be established for known future expenses." S. Rep. 372, 84th Cong., 1st Sess. 3 (1955). Congress explained that Section 462 would allow taxpayers to deduct estimated amounts of "certain liabilities for self-insured injury and damage claims," exactly the types of claims at issue here. H.R. Rep. 1337, 83d Cong., 2d Sess. A163 (1954); S. Rep. 1622, 83d Cong., 2d Sess. 63, 305-307 (1954).

The radical change brought about by Sections 462 and 452 was short-lived. Congress repealed those provisions retroactively less than one year later, prompted by warnings from the Treasury Department "that the proposed endorsement of such [methods of] accounting would have a disastrous impact on the Government's revenue." *American Automobile Ass'n* v. *United States*, 367 U.S. at 695. See Act of June 15, 1955, ch. 143, §§ 1, 3, 69 Stat. 134-135.[4] The taxpayer in *American Automobile Ass'n* contended that Congress's retroactive repeal of these

[4] The Treasury Department had revised upward its projection of estimated revenue loss due to these provisions from $47 million to $1 billion. H.R. Rep. 293, 84th Cong., 1st Sess. 3 (1955).

provisions should not be interpreted to preclude use of the reserve method of accounting that it employed, but the Court held that this contention " 'varnish[ed] nonsense with the charm of sound' " (367 U.S. at 695). "[T]he cold fact," the Court said, "is that [Congress] repealed the only law incontestably permitting the practice upon which the [taxpayer] depends" (*ibid.*). In terms equally appropriate to the instant case, this Court characterized the retroactive repeal of Sections 452 and 462 as "a mandate from the Congress that [the taxpayer's] system was not acceptable for tax purposes. To interpret its careful consideration of the problem otherwise is to accuse the Congress of engaging in sciamachy." 367 U.S. at 695-696.

Congress thus has specifically considered and, upon reconsideration, rescinded a provision that would have allowed tax deductions for reserves established in accordance with generally accepted financial accounting principles. And there can be no doubt that the $5.5 million reserve for which respondent seeks a deduction here is precisely the sort of reserve that Congress had in mind in 1954. The Claims Court, though it allowed respondent to deduct additions to the IBNR account, recognized that it was an ordinary reserve. See Pet. App. 8a-9a, 13a-14a, 16a-17a. Indeed, the IBNR account was literally taken off the books of the insurance companies, where it was indubitably a reserve, and placed upon respondent's own books. The amount contained in the IBNR reserve does not reflect any knowledge on respondent's part of the numerous future liabilities (in the form of potential claims for reimbursement) that the account is designed to represent. Rather, it is purely an estimate (and a poor one at that, being off by approximately $1 million) derived from a statistical

analysis of claims that had been paid in the past by respondent's insurers and of the "lag time" that in the past had typically intervened between its employees' receipt of medical services and the insurers' tender of reimbursement. See Pet. App. 8a-9a & n.1.

It is of course likely that history will repeat itself, more or less, and respondent's estimate of its probable future liability may be quite a useful thing for financial accounting purposes. But it simply does not represent an "incurred" expense that can form the basis for an income tax deduction in the year the estimate is placed on the books of the corporation. As this Court explained in *Thor Power Tool Co.*, 439 U.S. at 543, "[f]inancial accounting * * * is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty." "[R]easonable estimates may be useful, even essential, in giving shareholders and creditors an accurate picture of a firm's overall financial health; but the accountant's conservatism cannot bind the Commissioner in his efforts to collect taxes" (*ibid.*). The words that Justice Brandeis penned for the Court in 1934 are thus equally true today: "Only a few reserves voluntarily established as a matter of conservative accounting are authorized by the Revenue Acts." *Brown* v. *Helvering*, 291 U.S. at 201-202.

2. a. As Justice Brandeis intimated, of course, the general rule that accounting reserves are unacceptable for tax purposes yields in those instances where Congress has explicitly authorized particular categories of taxpayers to use reserves for specified purposes. Since 1939, for example, the Code has provided that taxpayers in general shall "be allowed (in the discretion of the Secretary) a deduction for a

reasonable addition to a reserve for bad debts." I.R.C. § 166(c); see Internal Revenue Code of 1939, ch. 1, § 23(k)(1), 53 Stat. 13. The Code currently authorizes somewhat more generous bad debt reserves for banks and S&L associations. See I.R.C. §§ 585, 586, 593.[5] And of particular relevance to the present case, the Code for over 60 years has authorized the use of various types of reserves, including IBNR reserves, by insurance companies. Because respondent is not an "insurance company," these provisions strongly suggest that the deduction respondent seeks for its IBNR reserve is impermissible.

In 1921, Congress concluded that the then-existing system of taxing insurance companies under the same provisions applicable to other corporations was unsatisfactory. Accordingly, Congress established special provisions for the taxation of life insurance companies (Revenue Act of 1921, ch. 136, §§ 242-245, 42 Stat. 261) and other insurance companies (*id.* §§ 246-247, 42 Stat. 262-263). These provisions have been amended on numerous occasions on the road to their present incarnation in Subchapter L (I.R.C. §§ 801-845), but at all times since 1921 insurance companies have been taxed under provisions inapplicable to other enterprises.[6]

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[5] This venerable exception to the general prohibition against the use of reserves for tax purposes appears likely to be narrowed soon. The House version of the 1986 tax reform bill would eliminate the availability of bad-debt reserves for banks with assets in excess of $500 million, and news reports indicate that that provision has been retained by the Conference Committee. See H.R. 3838, 99th Cong., 1st Sess. § 801 (1985); N.Y. Times, Aug. 18, 1986, at B7.

[6] See generally Tye, *Taxation of Insurance Companies*, 2 Tax L. Rev. 509 (1947); Vickrey, *Insurance Under the Federal Income Tax*, 52 Yale L.J. 554 (1943); *Alinco Life Ins. Co.* v. *United States*, 373 F.2d 336, 345-348 (Ct. Cl. 1967).

Significantly, Subchapter L contains some of the few instances in which the Code specifically authorizes the use of reserve accounting. Section 807 provides in detail for the use of reserves—generally required and regulated by state law—by "life insurance companies" as defined in Section 816. See I.R.C. §§ 807, 816(a) and (b). Casualty insurance companies are similarly entitled to deduct reserves set up in accordance with standard industry practice to cover "unpaid losses" suffered during the taxable year. See I.R.C. § 832(b)(5); Treas. Reg. § 1.832-4(b) (requiring casualty insurance companies to satisfy the Commissioner that reserves for unpaid losses reflect "amounts which, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay"). Specifically, the "incurred but not yet reported" or "IBNR" reserves generally maintained by casualty insurance companies may be deducted by those companies pursuant to Subchapter L. See generally *Maryland Savings-Share Ins. Corp.* v. *United States*, 644 F.2d 16, 24-25 (Ct. Cl. 1981). In the instant case, for example, the Claims Court noted that, "[p]rior to October 1, 1972, Aetna and Prudential deducted their IBNR reserves in the taxable year [in which] the [medical] services were received" by respondent's employees. Pet. App. 8a.

Thus, the Code does provide special authorization *for insurance companies* to use reserves analogous to the one that respondent seeks to deduct here. Although the courts below adverted to this fact, they refused to draw the negative inference that we believe should properly be drawn from it. The Claims Court noted that respondent's method of computing

its IBNR reserve "reflected accepted insurance company practice" and that "insurance companies can and do deduct such reserves" (Pet. App. 9a). That is certainly true and, indeed, is something of an understatement. Respondent did not merely compute its reserve in accordance with accepted insurance company practice; it established its IBNR account by literally transferring to its own books the precise amount that its insurers had previously maintained in *their* IBNR reserves in connection with respondent's policies.[7] And in augmenting its IBNR reserve at the end of the year, respondent added an amount that was explicitly based on the recommendations of its former insurers. Pet. App. 8a-9a & n.1.

But the fact that respondent has rather accurately mimicked insurance company practice in setting up its IBNR account does not entitle it to a tax deduction. The Code expressly limits to insurance companies the authorization to deduct insurance reserves, and respondent, as it concedes (Br. in Opp. 22), is not an "insurance company." The fact that the Code makes special provision for insurance companies to deduct these reserves strongly suggests that they are not generally deductible by other taxpayers, else the special provision for insurance companies would be

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[7] When respondent terminated its outside insurance policies and made the shift to self-insurance, its insurers paid to it the funds represented by the initial IBNR reserve amount in return for respondent's assumption of the potential liability for the claims reserved against. Although the record is silent on the matter, respondent stated in the court of appeals (C.A. Br. 48 n.**) that this amount was included in its taxable income, apparently as a refund of insurance premiums that it had previously paid to the insurance companies and deducted on its tax returns. See *Hillsboro Nat'l Bank* v. *Commissioner*, 460 U.S. 370 (1983).

superfluous. Hence, the very fact that respondent's IBNR reserve is a copy of those maintained by insurance companies provides weighty evidence that the court of appeals erred in allowing respondent to take a current deduction for additions to that reserve.

b. This Court has long recognized that ordinary taxpayers may not avail themselves of the specialized treatment that the Code has conferred on insurance companies. In *Brown* v. *Helvering*, *supra*, the Court rejected the taxpayer's claim that he was entitled to take a deduction for anticipated "return premium" expenses—a deduction that the Code explicitly made available to insurance companies. "The simple answer," the Court explained, "is that the [taxpayer] is not an insurance company; * * * the deductions allowed for additions to the reserves of insurance companies are technical in character and are specifically provided for in the Revenue Acts" (291 U.S. at 201).

The principle enunciated in *Brown* v. *Helvering*, *supra*, has also been applied by numerous lower courts that have refused to permit taxpayers to deduct additions to so-called "self-insurance" reserves.[8] A taxpayer that wishes to provide against potential future liabilities generally has two options at its disposal. It may purchase insurance from an outside carrier, the purchase price being represented by the obligation to pay annual premiums. If the taxpayer is unable to acquire insurance from an outside carrier, or if it believes such insurance to be too expensive, it may elect instead to "self-insure," that is, to undertake to

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[8] The term "self-insurance," of course, is strictly speaking an oxymoron, since it is impossible for a person to "insure" himself. See generally *Helvering* v. *Le Gierse*, 312 U.S. 531 (1941).

discharge future liabilities out of its own funds. In the latter event, the taxpayer's undertaking will typically be reflected on its balance sheet by a reserve account set up to cover those estimated future costs.

When a taxpayer elects to buy insurance from an outside carrier, the premiums paid or incurred are of course deductible currently as business expenses. See I.R.C. § 162; Treas. Reg. § 1.162-1(a) ("Among the items included in business expenses are * * * insurance premiums against fire, storm, theft, accident, or other similar losses."). When a taxpayer elects to "self-insure," on the other hand, the courts have consistently denied deductions for additions to the self-insurance reserve, reasoning that the taxpayer has not externalized or "shifted" the risk of loss to another party by the payment of premiums, and that the taxpayer has not parted with anything by establishing a mere "reserve account" on its books. See, *e.g.*, *Steere Tank Lines, Inc.* v. *United States*, 577 F.2d 279 (5th Cir. 1978), cert. denied, 440 U.S. 946 (1979). And the courts have reached the same result where a corporate taxpayer undertakes to pay purported "premiums" to a wholly-owned or "captive" insurance company, correctly reasoning that there is no externalization or distribution of risk given the identity of interests between the so-called "insurer" and so-called "insured." See, *e.g.*, *Beech Aircraft Corp.* v. *United States*, No. 84-2658 (10th Cir. Aug. 6, 1986); *Carnation Co.* v. *United States*, 640 F.2d 1010 (9th Cir.), cert. denied, 454 U.S. 965 (1981). See generally Rev. Rul. 77-316, 1977-2 C.B. 53; Bradley & Winslow, *Self-Insurance Plans and Captive Insurance Companies—A Perspective on Recent Tax Developments*, 4 Am. J. Tax Pol'y 217 (1985); O'Brien & Tung, *Captive Off-Shore Insurance Corporations*, 31 N.Y.U. Inst. Fed. Tax'n 665 (1973).

c. The precept that the special treatment accorded by the Code to insurance companies cannot be extended by analogy to other taxpayers is thus well established in this Court's decisions and in the decisions of the lower courts. This distinction between "insurance" and "self-insurance," moreover, is not merely a technical one, but is rooted in the fundamental policy goal of obtaining an accurate statement of income for tax purposes. The legislative history of the short-lived Section 462 of the 1954 Code demonstrates that Congress did not view "self-insurers" as at all analogous to insurance companies. Both committee reports listed estimates of "certain liabilities for self-insured injury and damage claims" as among the expenses that the now-repealed Section 462 was meant to permit taxpayers to deduct. H.R. Rep. 1337, *supra*, at A163; S. Rep. 1622, *supra*, at 63, 305-307. Clearly, Congress's view was that reserves for estimated expenses could not have been accrued by ordinary taxpayers before the enactment of Section 462, and the calculated repeal of that Section was "a mandate from the Congress" that an accounting method entailing such reserves "was not acceptable for tax purposes" (*American Automobile Ass'n* v. *United States*, 367 U.S. at 695).

The reasons why self-insurers like respondent should not be given the benefit of reserve deductions available to insurance companies are fairly clear. "Self-insurance is not the equivalent of insurance" (*Beech Aircraft Corp.* v. *United States*, slip op. 5), and respondent is not like an insurance company at all. It is subject neither to state regulation that applies to insurance companies nor to the provisions of the Internal Revenue Code that generally apply to such companies. It is not engaged in the insurance

business of spreading risk among various policyholders. See *Helvering* v. *Le Gierse*, 312 U.S. 531, 539 (1941). Rather, it simply has undertaken as part of its collective bargaining agreement to provide certain health benefits to its employees as a wage substitute. Respondent could provide those benefits through a conduit by taking out an insurance policy, but instead it has chosen, by becoming a "self-insurer," to provide the benefits directly.

More importantly, the peculiarities of insurance companies that impelled Congress to give them special tax treatment, including the right to use IBNR reserves, do not apply to ordinary taxpayers like respondent. An insurance company receives large amounts of income in the form of premium payments. The company does not have unrestricted use of those funds, however, because state law requires it to reserve a substantial portion in order to pay future claims under the policies for which the premiums have been paid. If the Code did not permit the company to accrue the additions to its IBNR reserve, the result would be an unrealistic overstatement of income in the year the premiums were received because of the inclusion of all of the premium income without any offset for related expenses. See *Bituminous Casualty Corp.* v. *Commissioner*, 57 T.C. 58, 77 (1971). This mismatching problem plainly is not found in the case of a self-insurer like respondent, who receives no premium income and is not subject to analogous state law restrictions on the use of its funds. Rather, the IBNR reserve established by respondent is little different from any other reserve established by a taxpayer in anticipation of probable future expenses, and respondent should not be able to take a current deduction for additions to that reserve.

B. Respondent's Attempt To Deduct Additions To Its IBNR Reserve Fails The "All Events" Test

In its brief in opposition, respondent professes to disagree with few of the general propositions that we have outlined above. Respondent concedes that its IBNR account is a garden-variety reserve, that taxpayers generally are precluded from deducting self-insurance reserves, and that it cannot avail itself of the special provisions permitting IBNR reserves to be deducted by insurance companies. See Br. in Opp. 21-22. Respondent contends, however, that these propositions are irrelevancies in the instant case, asserting that its particular IBNR reserve also happens to qualify for deduction under the "all events" test governing deductions by accrual-basis taxpayers generally.

In light of the general hostility of the tax system to the use of reserves, and in light of Congress's specific decisions to authorize the use of IBNR reserves by insurance companies and to rescind a short-lived provision that would have allowed other taxpayers to use them, respondent's contention should be greeted at the threshold with a healthy degree of skepticism. In any event, we shall demonstrate that respondent's contention is incorrect. The idea that any taxpayer has always been free to deduct an IBNR reserve under the general standard applicable to accrual-basis taxpayers—an idea that respondent convinced the courts below to accept—rests on a serious misapplication of the "all events" test. Applied correctly, the test confirms that respondent is not entitled to take a current deduction for its estimate of its potential future liabilities. In the words of the Tax Court, the deduction of casualty insurance reserves by ordinary accrual-basis taxpayers is "fundamentally at odds

with the 'all events' test." *Bituminous Casualty Corp.* v. *Commissioner*, 57 T.C. at 77.

1. The "all events" test has been the standard for determining when an item of expense is to be regarded as "incurred" for federal tax purposes for almost sixty years. The test originated in *United States* v. *Anderson*, 269 U.S. at 441, where this Court stated that an expense may be accrued in the year in which "all the events * * * occur which fix the amount * * * and determine the liability of the taxpayer to pay it." The "all events" test has since been incorporated in the Treasury Regulations. See Treas. Reg. § 1.446-1(c)(1)(ii) (accruals in general), § 1.451-1(a) (accrual of income), § 1.461-1(a)(2) (accrual of deductions). The test has come to ~~the~~ be recognized as "a fundamental principle of tax accounting" and as " 'the "touchstone" for determining the year in which an item of deduction accrues.' " *United States* v. *Hughes Properties, Inc.*, slip op. 6 (quoting *United States* v. *Consolidated Edison Co.*, 366 U.S. 380, 385 (1961)).[9]

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[9] In 1984, Congress set forth for the first time a statutory definition of the "all events" test, providing that "the all events test is met with respect to any item if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy." Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 91(a), 98 Stat. 598-601 (adding I.R.C. § 461(h)(4)). This definition, of course, accords with that previously enunciated by this Court and by the Treasury Regulations. This definition was enacted as part of a broader amendment designed to establish more specific rules for accrual of deductions—rules that entail postponement of the accrual of some deductions that might be held to satisfy the "all events" test—by requiring that expenses generally not be accrued until "economic performance" has occurred. I.R.C. § 461(h) and (i). Section 461(h)(1) of the Code now provides that, "in determining whether an amount has been incurred with

The "all events" test has two elements, both of which must be satisfied before accrual of an expense is proper. First, "all the events [must] have occurred which establish the fact of the liability giving rise to [the] deduction" (Treas. Reg. § 1.446-1(c)(1)(ii)). Second, the amount of the deduction must be capable of being "determined with reasonable accuracy" (*ibid.*). The second part of the test permits a degree of computational flexibility. See *Lucas* v. *American Code Co.*, 280 U.S. at 450; Treas. Reg. § 1.461-1(a)(2). But the Regulations emphasize that the first part of the test is absolute: "no accrual shall

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respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs." Where the taxpayer's liability arises from the provision of goods or services, or from the use of property, "economic performance" is generally deemed to occur when the goods or services are actually provided, or when the property is actually used (I.R.C. § 461(h)(2)(A) and (B)). Where the taxpayer's liability arises from a workers' compensation statute or tort, "economic performance" is deemed to occur when payments to the recipient are actually made (I.R.C. § 461(h)(2)(C)). The 1984 Act makes an exception to this general rule for "certain recurring items" (I.R.C. § 461(h)(3)). Such items may be deducted in the year preceding economic performance if the "all events" test is met and if several other conditions specified in the statute are satisfied—including the requirement that economic performance actually occur within a "reasonable period" (typically, 8½ months) after the close of the tax year. These provisions, which are generally effective for post-1983 tax years (Pub. L. No. 98-369, § 91(g), 98 Stat. 608), have no application to the instant case, which involves respondent's tax liability for 1972. The decision in this case, however, will be highly relevant to the administration of the new provisions because the applicability of the "recurring items" exception turns in part on whether the "all events" test is met.

be made in any case [unless] all of the events have * * * occurred which fix the liability" (*ibid.*).

This Court has used various phrases to describe the effect of the "all events" test. To be deductible for federal tax purposes, "the obligation to pay [must] ha[ve] become final and definite." *Security Flour Mills Co.* v. *Commissioner*, 321 U.S. 281, 287 (1944). It must be "fixed and absolute." *Brown* v. *Helvering*, 291 U.S. at 201. It must be "unconditional." *Lucas* v. *North Texas Lumber Co.*, 281 U.S. 11, 13 (1930). And, more recently, the Court has explained that a deduction must be deferred "until all the events have occurred that will make it fixed and certain." *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. at 543 (original quotation marks omitted). See generally *United States* v. *Hughes Properties, Inc.*, slip op. 6-7.

Regardless of the formulation chosen, respondent's contention that it can deduct additions to its IBNR reserve simply does not satisfy the necessary conditions. It clearly fails the first part of the "all events" test.[10] This failure is manifest when one considers the multiple events that had to occur before respondent had any "fixed obligation" to reimburse its em-

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[10] We note that it is highly questionable whether respondent's claimed deduction meets the second part of the "all events" test either. The disparity between the estimated liability of $5,575,289 and respondent's actual payments of $4,583,893 is approximately $1 million. See Pet. App. 16a. We do not agree that an estimation error of nearly 20% for amounts of this magnitude is a determination "with reasonable accuracy" within the meaning of the "all events" test. Although the courts below rejected our contention in this respect, we have not presented the "reasonable accuracy" issue for this Court's review because of the essentially factual nature of that question. See Pet. 13 n.2.

ployees—a chain of events that was not complete until after respondent's 1972 tax year closed.

When respondent originally entered into its collective bargaining contracts, it could reasonably have assumed, as a matter of probability, that it would ultimately have to pay out substantial sums to reimburse employees for medical services that they would incur. It might have been prudent for respondent to set up a reserve on its books at that time in order to reflect its duty to pay reimbursement over the life of the contracts. But respondent was plainly under no obligation to pay reimbursement to anyone when it signed the contracts, and it thus could not properly have accrued such a liability at that time.

When respondent closed the books on its 1972 tax year, it again reasonably assumed, as a matter of probability, that some of its employees had gone to the doctor during 1972 without yet being reimbursed, and that it would ultimately have to reimburse them for the medical services that they presumably had received. It was thus prudent for respondent to establish a reserve on its books in order to reflect its probable liability to pay those estimated sums in post-1972 tax years. But respondent at the close of 1972 still had no obligation to pay anyone the amounts reflected in its IBNR reserve. On our view, therefore, respondent could not properly accrue such a liability then, any more than it could properly have accrued such a liability when it signed the collective bargaining contracts to begin with.

When respondent subsequently learned that some of its employees had in fact gone to the doctor during 1972, that information would have further increased the probability that respondent would ultimately have to pay some reimbursement, and it perhaps would have given respondent data from which to estimate

its potential liability more accurately. But respondent at that time still had no obligation to make any payment to anyone. Rather, under the terms of the health plans established pursuant to the collective bargaining contracts, respondent had no obligation to pay, and did not in fact pay, any reimbursement unless and until (1) an employee submitted a claim complete with supporting documentation and (2) respondent and its agents processed the claim and thereby satisfied themselves that the claim qualified for payment in a determinable amount. Until these two events occurred, respondent had no "fixed and certain" obligation to pay out any funds. And as to every putative obligee-employee reflected in the IBNR reserve at the end of 1972, one or both of these conditions had not yet been met.

Many of the employees that respondent assumed to have received medical services during 1972 had not submitted any claim for reimbursement before the year ended. See Pet. App. 8a. It was entirely possible, moreover, that some of those employees would never submit a claim at all. Some might regard the medical expenses that they had incurred as too insignificant to warrant the trouble of seeking reimbursement. Some might prefer that their employer's agents not learn that they had undergone treatment for certain medical conditions. And some might fail to submit claims because of inadvertence or neglect. In all of these instances, respondent would never be required to make reimbursement because it was not obliged to pay until an employee filed a claim in writing supported by appropriate documentation. Respondent's obligation to reimburse employees who had received medical services in 1972, but who had submitted no claims before the year ended, was thus

neither "unconditional" nor "absolute" as of December 31, 1972.[11]

The fact that an employee's filing of a claim is one of the events necessary to "establish the fact of liability" under respondent's health plans is alone enough to require the rejection of any IBNR reserve deduction. That deduction also fails, however, because there is yet one additional and final event that must occur before the health plans create a fixed obligation to pay—the approval of the claim for payment after consideration and investigation by respondent and its agents. Once an employee has actually submitted a claim, respondent maintains the right to refuse reimbursement on numerous grounds. Claims can be denied, inter alia, on the ground that the treatment was not covered by the health plans, that the treatment was not "medically necessary," that the charges exceeded those that are reasonable and customary, that the illness for which the treat-

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[11] Indeed, the testimony of respondent's own witness demonstrates that respondent had no obligation to reimburse employees until a claim was actually filed. J. David Loftus, a claim administrator for Aetna, testified that respondent's plan generally provided time limits of 90 days for the filing of some claims and one year for the filing of other claims (J.A. 130). He further testified that claims filed outside this time period were usually processed in normal fashion if filed within two years of the medical treatment, but that claims filed later were usually questioned (J.A. 130-131). Mr. Loftus stated that, even in the case of extremely tardy claims, the company would sometimes "waiv[e] our right to deny [the] claims" (J.A. 131). But regardless whether respondent was so generous as to make payment in the face of such untimeliness, its recognition that payment in these circumstances was a waiver of its "right to deny" the claims is flatly inconsistent with its contention here that it was bound by an unconditional obligation to pay as soon as an employee received medical services.

ment was sought was a "pre-existing condition," or that the expenditures otherwise failed to qualify as a "covered medical expense." Although the Claims Court characterized the claims processing procedures as "ministerial" and "administrative" (Pet. App. 12a),[12] the court found that only 90% of the amounts claimed by respondent's employees, on average, were actually approved for payment (*id.* at 12a-13a). Because there thus existed a substantial possibility that any particular claim, once filed, would be denied in whole or in part, respondent's obligation to make payment to these individuals, like its liability to pay those who had not filed claims at all, was neither "uncon-

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[12] The record in fact refutes the Claims Court's statement that processing of claims was "ministerial." Many claims, of course, were paid by respondent without dispute, but the direct testimony of respondent's own witness gave examples of "gray areas" in which special processing and investigation by supervisors would be necessary in order for respondent to determine its view as to what the proper amount of reimbursement would be. See, *e.g.*, J.A. 134. Indeed, one of the principles of Prudential's "claim philosophy," which was put forth by respondent as illustrative of how its plan was administered, is that "[a]ny questionable claim will be thoroughly investigated and fully documented before a decision is made" (J.A. 177). Respondent's reliance (Br. in Opp. 6-7) on the fact that relatively few lawsuits were filed in connection with its health plans, as compared with the number of claims filed, is quite misplaced. Most health insurance claims involve relatively small sums that would not warrant the expense of litigation. The number of lawsuits gives no indication at all of how many of respondent's determinations were disputed by employees, successfully or unsuccessfully, at the administrative level. It is well settled, of course, that a liability can be "contested," and therefore contingent for accrual purposes, without the filing of a lawsuit. See Treas. Reg. § 1.461-2(b)(2); *Dixie Pine Co. v. Commissioner, supra.*

ditional" nor "absolute" at the close of the 1972 tax year.[13]

2. a. The Claims Court below held that respondent's liability "was not based on the filing of a claim" but rather became "fixed under the * * * self-insured plans upon occurrence of the insured event—the receipt of covered services by [respondent's employees]" (Pet. App. 15a). Respondent similarly contends that, "[o]nce the [medical] services were received," its obligation to pay reimbursement "was contingent no longer" because it "could not avoid liability" (Br. in Opp. 14). But this statement is simply incorrect. Even after an employee had received medical services, respondent would indisputably

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[13] If the employee's filing of a claim, rather than respondent's processing and approval of the claim, were held to be the "last event" necessary to fix respondent's obligation to pay reimbursement, there would still be no basis on the record in this case to allow respondent to deduct any portion of its IBNR reserve. In constructing that reserve, respondent made no reference to employees' actual receipt of medical services, or to employees' actual filing of claims, during 1972. Rather, respondent used statistics from prior years that showed the aggregate amount of claims typically paid and the average "lag time" between employees' receipt of services and the insurers' tender of reimbursement. Given this mode of construction, it would be no easy matter to "break down" respondent's 1972 year-end IBNR balance into two components, one reflecting its potential liability on claims not yet filed, the other reflecting its potential liability on claims filed but not yet processed. In any event, respondent had the burden of proving its entitlement to a deduction (*Helvering* v. *Taylor*, 293 U.S. 507, 514-515 (1935)), and, as we have noted above (page 6, *supra*), respondent introduced no evidence that would permit its IBNR balance to be broken down in this way. It does appear, however, that the bulk of the reserve represents potential liability on claims not filed, since respondents advises (Br. in Opp. 5) that most of its employees' claims are processed "expeditiously."

"avoid liability" if (1) the employee did not file a properly-documented claim for reimbursement or (2) respondent determined that a filed claim did not qualify for payment. An employee's visit to a doctor, like respondent's antecedent signing of the collective bargaining agreement, was a necessary but insufficient condition to create an obligation to pay on respondent's part. An employee's receipt of medical services undeniably fixed that employee's liability to pay the doctor for the services that he had received. But respondent's liability was not to pay the doctor, but rather to reimburse the employee. And respondent had no obligation to reimburse any employee until that individual had filed a claim and that claim had been approved.

The fact that the seminal event triggering the liability under the collective bargaining agreement can be said to have occurred in 1972, is, of course, irrelevant under the "all events" test, which turns on when the obligation to pay becomes fixed and certain. Until it has resolved the uncertainty about reimbursement by approving the claim for payment, respondent is in precisely the same position as the taxpayer in *Lucas* v. *American Code Co.*, *supra*, who tried to take a deduction for a contractual liability that arose in the taxable year, but did not become certain until the resolution of a lawsuit at some future time. Under the "all events" test, tax accounting must look to the time when an obligation to make payment becomes certain, not to the moment when the underlying obligation arises in a contractual sense. In this case, that obligation did not become certain until a claim for reimbursement was filed and was processed by respondent.[14]

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[14] Several lower court decisions also illustrate this basic principle that underlies the "all events" test. For example, in

b. Besides failing to reflect *fixed* obligations, the amounts comprising respondent's IBNR reserve do not reflect any *actual* obligations, fixed or otherwise.

Trinity Construction Co. v. *United States*, 424 F.2d 302 (5th Cir. 1970), the court held that an accrual-basis taxpayer could not take a current deduction for future life insurance premiums that it was already contractually obligated to pay on behalf of its employees. Because the payments would not actually be made if the employee died before the premium was due, the obligation was not sufficiently certain to justify accrual. See also *Bennett Paper Corp.* v. *Commissioner*, 699 F.2d 450 (8th Cir. 1983) (contractual obligation under profit-sharing plan to pay bonuses in future years); *World Airways, Inc.* v. *Commissioner*, 62 T.C. 786 (1974), aff'd, 564 F.2d 886 (9th Cir. 1977) (contractual obligation to make future payments for statutorily-required engine overhauls).

In seeking to justify its expansive reading of the "all events" test, the Claims Court relied in part (Pet. App. 13a) upon a line of Ninth Circuit cases culminating in *Kaiser Steel Corp.* v. *United States*, 717 F.2d 1304 (1983). In *Kaiser Steel*, the Ninth Circuit held that an employer's obligation to make workers' compensation payments became "fixed" once the worker had been injured and the employer had either been found to be liable or had determined not to contest its liability; the Claims Court concluded that *Kaiser Steel* stood for the proposition that "the fact of *injury* establishes the fact of *liability*" (Pet. App. 13a (emphasis in original)). We believe that *Kaiser Steel* is distinguishable from the instant case in several respects. In *Kaiser Steel*, the following critical events had occurred before the close of the tax year: the employee had in fact been injured; the employee had actually filed a claim for workers' compensation benefits; and the employer had conceded liability on that claim. In the present case, by contrast, respondent as of the close of the tax year had no way of knowing whether any employees had in fact received medical services; the employees in any event had not filed claims for benefits; and respondent reserved the right to deny each claim in whole or in part. Although we believe that *Kaiser Steel* is fairly distinguishable on these grounds, we are frank to admit that we believe that the case was wrongly

Respondent made no effort to ascertain whether any employee had in fact received medical services before the close of the 1972 tax year. Rather, respondent simply assumed, based on projections from past experience of Aetna and Prudential, that a substantial number of employees had received covered medical services during this period, and that their claims ultimately would lead to more than $5.5 million in payments. The amounts shown in the IBNR reserve thus represented nothing more than an educated guess as to aggregate liability. Although it was of course likely that *some* employees had gone to the doctor during the last quarter of 1972, respondent could not definitively state that a single employee had incurred a single penny in covered medical services during that time. Respondent thus seeks to take a $5.5 million deduction without being able to identify any actual obligations that are reflected in that amount.

This sort of aggregate estimate is incompetent as a matter of law to "establish the fact of the liability" (Treas. Reg. § 1.446-1(c)(1)(ii)). It is well settled that a liability becomes "fixed" only when it is based

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decided. Contrary to the Ninth Circuit's view, the employer's obligation to pay was still contingent on the extent of the injured worker's future medical treatment, the duration of his disability, and other variables that could not be known until after the close of the taxable year. We note that Congress in 1984 specifically overturned the result in *Kaiser Steel*, providing that workers' compensation payments cannot be deducted until "economic performance" occurs, that is, until "payments to [the injured worker] are made." I.R.C. § 461(h)(2)(C)(i); see note 9, *supra*. The discussion of this amendment in the legislative history, entitled "Premature Accruals," criticized the *Kaiser Steel* line of cases as allowing "overstated deductions." H.R. Rep. 98-432, 98th Cong., 2d Sess. Pt. II, at 1252-1255 (1984).

on known facts respecting individual claimants; an estimate suggested by past experience is insufficient to satisfy the "all events" test. Respondent here is in the same position as the taxpayer in *Brown* v. *Helvering*, *supra*, who was practically certain that he would have a significant future liability for return premiums because past experience suggested that some policies written during any given year would inevitably be cancelled later on. See 291 U.S. at 197-198, 201 n.7. But this Court held that the taxpayer could not deduct his estimate of that aggregate liability because "[i]n respect to no particular policy written within the year could it be known that it would be cancelled in a future year." *Id.* at 201.

This Court sounded the same theme in *American Automobile Ass'n*, *supra*, when it explained that aggregate statistical estimates, while satisfactory for financial accounting purposes, are unacceptable in tax accounting. When a company projects an expense on a statistical basis "without regard to * * * individual expense * * *, but consistently with overall experience, [its] accounting doubtless presents a rather accurate image of the total financial structure, but [it] fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner." 367 U.S. at 692. In short, " 'the fact that the percentage of items which will be paid can be estimated with reasonable accuracy is not sufficient to support accruals. The individual items must represent fixed liabilities.' " *Union Pac. R.R.* v. *United States*, 524 F.2d 1343, 1351 (Ct. Cl. 1975), cert. denied, 429 U.S. 827 (1976) (quoting *Denver & Rio Grande Western R.R.* v. *Commissioner*, 38 T.C. 557, 572 (1962)).

c. The impermissibility of respondent's attempt to deduct a statistical estimate of its aggregate lia-

bility is well illustrated by the course of decisions in *Milwaukee & Suburban Transport Corp.* v. *Commissioner*, 18 T.C.M. (CCH) 1039 (1959), rev'd in part, 283 F.2d 279 (7th Cir. 1960), vacated and remanded, 367 U.S. 906, on remand, 293 F.2d 628 (1961). The facts there were quite similar to those here. The taxpayer created on its books a self-insurance reserve representing its year-end estimate of the probable amounts that it would have to pay in the future on claims arising out of accidents in which its equipment was involved during the taxable year (18 T.C.M. at 1049). Part of this reserve reflected anticipated liability on "potential claims" that had not been filed before the close of the tax year (*id.* at 1048, 1050). The balance reflected anticipated liability on claims that had been filed but on which the taxpayer either actively contested or "did not during [the taxable] year[] admit its liability" (*id.* at 1049-1050). The taxpayer conceded that it had no specific year-end liability to any individual claimant, but argued that, if the claims were "viewed in the aggregate, it [could] be taken as certain that [it would] have some liability and that estimates of its total net liability with respect to the aggregate of [the] claims" should be deductible (*id.* at 1050). The Tax Court, relying on this Court's decision in *Brown* v. *Helvering*, *supra*, rejected the taxpayer's argument, refusing to permit the taxpayer to deduct "a reserve for contingent liabilities in respect of unsettled and potential claims" (18 T.C.M. at 1050-1051 (citing 291 U.S. at 201)).

The Seventh Circuit reversed the Tax Court's judgment on this issue and held that the reserve was deductible (283 F.2d at 283-288). The court of appeals emphasized that "[t]he accidents out of which

the various claims gr[e]w undoubtedly ha[d] occurred" during the taxable year (283 F.2d at 286), and it held that this was sufficient to fix the taxpayer's liability under the "all events" test. "Because of the number of claims," the court reasoned, "it is apparent to everyone that there is going to be liability, and the only question is [o]n which particular claims this liability will occur. * * * If overall liability can be accurately predicted, there should not be any objection to the fact that it cannot be tied down securely [o]n any particular claim" (*id.* at 287).[15]

The Commissioner petitioned for certiorari. *Commissioner* v. *Milwaukee & Suburban Transport Corp.* (No. 843, 1960 Term). This Court granted the petition, vacated the Seventh Circuit's judgment, and remanded for reconsideration in light of *American Automobile Ass'n* v. *United States*, *supra*. See 367 U.S. 906 (1961) (citing 367 U.S. 687). On remand, the Seventh Circuit recalled its mandate, vacated its judgment, and affirmed the Tax Court "with reference to the accounting method issue." 293 F.2d 628 (1961). In so doing, the Seventh Circuit correctly concluded that the deduction of a self-insurance reserve representing a mere statistical estimate of aggregate liability is impermissible under the reasoning that this Court adopted in *American Automobile Ass'n*. That conclusion is equally applicable in the

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[15] In so holding, the Seventh Circuit relied heavily on a case that it viewed as "directly on point," *Ocean Accident & Guarantee Corp.* v. *Commissioner*, 47 F.2d 582 (2d Cir. 1931). But the court overlooked the crucial difference between *Ocean Accident* and the case before it, viz., that the former involved an insurance company, which Congress has specifically permitted to deduct reserves. See pages 21-29, *supra*.

instant case, and we believe that it dictates reversal of the Federal Circuit's judgment.

d. Respondent suggests (Br. in Opp. 6, 15, 20) that the lack of certainty in its IBNR reserve is not a theoretical problem, but only a practical difficulty that assertedly arises because it is a large corporation with many employees. "If a claims processor had been at the hospital on the day an employee was discharged," respondent says, "the processor could have processed and calculated the amount of the medical benefit at that time" (Br. in Opp. 6). Respondent points out that it "had approximately 56,000 employees in 1972" and that to have stationed claims processors at multiple locations around the country would have entailed an unreasonably burdensome expense (*id.* at 20). Because an employer with relatively few employees could accomplish this feat more inexpensively, and thus satisfy the "all events test" on our view of the law, respondent concludes that our position discriminates against large employers and thus produces an "irrational and unjustifiable" result (Br. in Opp. 20).

This contention is quite beside the point. Respondent of course is correct in asserting that (1) if it had stationed a claims processor at the doctor's office and (2) if the processor had given a claim form to the employee and (3) if the employee had filled out the form and submitted it to the processor and (4) if the processor had reviewed the claim and approved it for payment in full and (5) if all those events had occurred before December 31, 1972, then respondent would have been able to deduct its liability to reimburse that employee as a 1972 business expense. But that is only to say that respondent could have structured its medical plan in a way that would have

enabled it to pass, rather than doomed it to fail, the "all events" test. Obviously, whenever the timing of a deduction is at stake, a taxpayer may have at his disposal various steps that he might take to accelerate into the current tax year the "last event" necessary to fix his obligation, with the result that he would qualify for a current tax deduction. In deciding whether to take those steps, a cost-efficient taxpayer will compare the expense of doing so to the benefit he would gain, in terms of the time value of money, by getting his deduction this year rather than next. In the instant case, respondent decided not to station claims processors in doctors' offices around the country, and that decision was probably a rational economic judgment. But the consequence of that decision is that many claims for 1972 medical services were not filed by employees or approved by respondent until after the tax year closed, with the result that respondent failed the "all events" test and thus must defer its tax deduction until 1973 or later. A corporation that declines, for sensible business reasons, to undertake steps necessary to garner a current tax benefit cannot be heard to complain. As this Court put it in *Thor Power Tool Co.*, 439 U.S. at 545-546: "There is * * * no reason why [a taxpayer] should be entitled, for tax purposes, to have its cake and to eat it too."

e. The fact that respondent's IBNR reserve represented a mere statistical estimate of aggregate liability, rather than a set of specific and individualized obligations, highlights the sharp difference between this case and *United States* v. *Hughes Properties, Inc.*, *supra*. In *Hughes Properties*, the Court held that the taxpayer could accrue the amounts shown on the jackpot meters of its progressive slot machines at the

close of the taxable year. Nevada law created a statutory obligation for the taxpayer to maintain the amounts displayed on the meters and to pay them to the eventual winner. See slip op. 8. This Court held that this obligation was sufficiently "fixed and certain" to satisfy the "all events" test: "[a] part of the machine's intake was to be paid out, that amount was known, and only the exact time of payment and the identity of the winner remained for the future" (slip op. 10). In marked contrast to the situation in the instant case, the taxpayer's accountant in *Hughes Properties* could walk around its place of business at the close of the taxable year and point to the individual fixed obligations—emblazoned on the face of each progressive slot machine—that the taxpayer sought to deduct. Here, respondent cannot point to any specific and individual obligation at the close of the taxable year. It seeks, rather, to deduct an aggregate estimate of the liabilities that will become fixed in the future if and when individual employees file claims for reimbursement and those individual claims are approved for payment. Although Congress has chosen to permit insurance companies to deduct reserves computed in this way, Congress has not extended that benefit to ordinary accrual-basis taxpayers, and this Court's decisions confirm that the deduction respondent seeks for its IBNR reserve is impermissible.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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